UNITED NATIONS
ECONOMIC AND SOCIAL COUNCIL

Distr.
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E/ECA/AFEA/90/7
E/ECA/PSD.6/8.2

AFRICA ECONOMIC ASSOCIATION
INAUGURAL CONFERENCE AND
SCIENTIFIC COLLOQUIUM

Addis Ababa, Ethiopia
16 - 19 January 1990

JOINT CONFERENCE OF AFRICAN
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DEMOGRAPHERS

Addis Ababa, Ethiopia
15 - 20 January 1990

STUDY ON MULTIPLE EXCHANGE RATES SYSTEM (MERS) AND DIFFERENTIAL INTEREST RATES POLICY (DIRP)

by

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E/ECA/ATRD/90/7
E/ECA/PSD.6/8.2

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I N T R O D U C T I O N

Developing countries in recent years have been experiencing increasing balance of payments difficulties which are mainly attributable to their foreign exchange operation. In an effort to overcome these problems and reestablish favourable conditions for economic growth and a sustainable balance of payments positions, many countries resort to various monetary policy instruments including interest rate and exchange rate adjustments.

One of the most serious factors that limit the role of, and scope for, monetary policy in developing countries is the lack of development in their financial structure. In most developing countries, the ratio of currency to the stock of money is relatively large. This, together with the small number of banks, limits the capacity of the banking system to create additional credit on the basis of an increase in the reserves of the commercial banks. The non-monetized portion of the economy is not susceptible to central bank influence, and this may be relatively large in some countries. Furthermore, because of the fragmentation or non-existence of money and capital markets, many monetary instruments, which are used effectively in industrial countries, are subject to technical constraints.

Monetary policy instruments which are available to achieve external payments equilibrium are exchange rate and interest rate policies. Thus, developing countries faced with balance of payments problems resort to exchange rate and interest rate adjustment. Exchange rate and interest rate adjustments may help return the economy to the normal and sustainable structure of production, aggregate employment level and balance of payments positions. However, the process of adjustment is not easy. Economic distortions that have prevailed for many years may be extremely difficult to eliminate. This strongly suggests that appropriate exchange rate and interest rate measures should be devised.

Several African countries, particularly Sub-Saharan African countries, have used the exchange rate as an instrument of policy in a balance of payment disequilibrium. Through this instrument,

some countries have been able to pursue realistic foreign exchange policies and have succeeded in maintaining currency stability and payments system. There are, however, many others whose balances of payments have been under serious and continuing pressure to the extent that they have to depend on quantitative restrictions of imports and exchange restrictions to maintain currency stability. Thus, many countries have questioned both the desirability and effectiveness of alteration in the exchange rate, particularly in a down ward adjustment of the exchange rate in their economies. As a result, the choice of an appropriate exchange rate system, which is a complex decision that has to take into account a wide variety of relevant factors, has become a basic question to be addressed.

In most African countries, interest rates are determined administratively rather than by market forces. As a result, interest rates in these countries are very low or negative. This situation has made the saving mobilization capacity, which is very crucial for increasing capital accumulation and enhancing financial and economic growth, to be very low. Thus, many people propose for frequent interest rate adjustments and for less interference of the governments. There are, however, who point out that, since governments' in African countries are responsible in the creation and provision of jobs and goods together with a vital investment role, they are justified in getting cheap credit. Indeed, the appropriateness of interest rates has been a subject of debate in the economic literature. It is, thus, important to undertake a study on how interest rate can be used more effectively keeping in view the special institutional as well as the structural characteristics of the economy under consideration.

Exchange rate and interest rate variations increase the access of a country to foreign capital, prevent the outflow of current domestic saving and cause a return flow of previously exported domestic saving, induce a rise in the remittances of nationals working abroad, and bring an inflow of foreign tourists. These will affect a country's production, consumption and trade payments structure, including tariffs, subsidies, and various forms of exchange controls. It would, therefore, be important to study, the appropriate exchange rate system and interest rate policy under a particular economic circumstances in order to achieve external payments stability. This study is a modest attempt in this direction in the context of African Alternative Framework to Structural Adjustment Programmes for Socio-Economic Recovery and Transformation (AAF-SAP).

African Alternative Framework to Structural Adjustment Programmes for Socio-Economic Recovery and Transformation is a proposal of new plan for economic revival. It provides a broad

framework of policy directions and policy instruments from which policy packages for specific country programmes are to be formulated in the course of adjustment with transformation. Among the recommended policy instruments to promote the operationalization of the framework are Multiple Exchange Rate Systems (MERS) and Differential Interest Rates Policy (DIRP).

The purpose of this paper is to conduct a detailed investigation of the adequacy of the two key policy instruments which can be recommended to promote the operationalization of African Alternative Framework for Structural Adjustment Programmes for Socio-Economic Recovery and Transformation (AAF-SAP).

The paper is divided into two parts. Part A deals with multiple exchange rate systems, while Part B examines differential interest rates policy. Section I of Part A presents the theoretical basis for multiple exchange rate system. Section II reviews the experiences of three Sub-Saharan African countries, namely Uganda, Zambia and Nigeria. In section III the application of multiple exchange rate system in the content of AAF-SAP is examined. Section I of Part B deals with the theoretical background of differential interest rate policy. Section II is devoted to the discussion of the application of DIRP in Sub-Saharan African countries. In section III, DIRP in the context of AAF-SAP is explored.

P A R T A

I. MULTIPLE EXCHANGE RATES SYSTEM (MERS

International trade deals with business transa[illegible]ions between different countries. Since no country is fully self [illegible]sufficient in factor endowments, countries interact through intern[illegible]tional trade to export goods and services in abundant supply and [illegible]import those in short supply. Consequently, international trade [illegible]ay be defined as the exchange of goods and services among countrie[illegible] It consists of the exchange by each country of its low-pri[illegible] goods and services for those goods and services which can be [illegible]red at lower prices abroad than at home. From these transacti[illegible]ns, countries earn foreign exchange.

However, such transactions require the [illegible]xistence of independent national currencies requiring exchange [illegible] one country's currency for another's before goods can be bought and sold. The purchase and sale of foreign currencies conducte[illegible] in the foreign exchange market and the rate at which one currency [illegible]s exchanged for another currency is known as the foreign exchange rate".[1] Thus, an exchange rate is the price of a unit of foreign currency in terms of domestic currency.

A country's total supply of foreign exchange is determined by the amount of export and other receivables in the form of loans or grants while the demand is determined by the total amount of imports or other payables in any other form to another country. Usually, the supply of and demand for foreign exchange are not in exact balance at the given exchange rate; then the government has to make up the difference by buying or selling its own currency for foreign exchange in order to maintain its value".[2] A country's ability to perform foreign trade will face serious problems if the supply of and demand for foreign exchange at the official exchange rate is out of balance. A persistent balance of payments deficit means that there will be an outflow of reserves from the country experiencing the deficit. The outflow of reserves may take the form of reductions in the domestic country's holding of gold or of key currencies that are widely used to carry out international exchange. As the deficit and the consequent outflow of reserves continue, the international liquidity position of the country is

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[1] M. C. Vaish, Money, Banking and International Trade, Vikas Publishing House Pvt. Ltd., New Delhi, 1980. Page 589

[2] Cheryl Payer, The Debt Trap, The IMF and The Third World, Monthly Review Press, London & New York, 1974. page 2

gradually diminished".[3] In the case of recurring deficits in balance of payments the government's foreign exchange will be exhausted by the perennial necessity to fill the gap by which demand for foreign exchange exceeds the supply. This is the situation which gives rise to a balance of payments crisis.

There are various methods of financing to solve payment crisis. Thus, improvements in the balance of payments may require reductions in the domestic level of income or increases in domestic interest rates or changes in relative price levels.[4] A change in foreign exchange rate will change the relationship between the relative prices of domestic goods and services and those of the foreign goods and services. Devaluing a country's currency lowers the prices of domestic goods for foreigners when expressed in terms of their national currencies. On the contrary, revaluation of currency raises the prices of domestic goods for foreigners. The same changes in the relative national prices could, however, be achieved through the differential rates of absolute price changes at home and abroad, keeping the foreign exchange rate stable.

The extent to which price changes can remove balance of payments disequilibrium depends upon the price elasticities of demand for imports at home and abroad. If the foreign demand for a country's exports is elastic, a given fall in their prices by causing a larger percentage increase in the physical quantity of exports demanded will cause increase in country's total foreign exchange receipts and vice versa. At home lower domestic prices of home made goods competing with higher-priced imports will nearly always lead to a greater fall in imports and consequently to a fall in the amount of foreign exchange demanded. Both these measures of correcting the balance of payments deficit disequilibrium have quite different effects in other respects on the economy.

Given the prices and foreign exchange rates, higher income at home leads to higher imports while higher income abroad will cause an increase in the exports of the country. Consequently, a deficit in the balance of payments of a country may be corrected through either a decrease in national and personal incomes at home or through an increase in national and personal incomes abroad.

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[3] R. Hosek William and Zahn Frank, Monetary Theory, Policy and Financial Markets, Mcgraw-hill Book Company, 1977. page 274

[4] R. Hosek William and Zahn Frank, Ibid, page 274

Other than policy instruments that work through market operations, there are also various non-market measures to influence the balance of payments. Exchange control is one of a balance of payments policy instruments available to achieve external balance. It is the most direct and immediately effective method for restricting imports and/or payments for invisibles and capital movements. The control may extend over a wide area, covering the import and export of goods and services, remittances from the country's inflow and outflow of capital, rate of exchanges, methods of payment, maintenance of balance in foreign centres, acquisition and holding of foreign securities, financial relationship between residents and non-residents etc.[5]
According to Chaudhuri, the main objective of exchange control is to maintain the value of the country's currency in terms of other currencies and to bring about an equilibrium in the country's balance of payments.[6] Thus, when a country is desperately short of foreign exchange, it resorts to control the expenditure of what is available to make sure that essential imports have priority. In Africa, as in other developing countries, this system helps to control an excessive demand for imports and to ensure that an adequate supply of foreign exchange is available to finance essential imports of goods and services.

Another alternative solution is import restrictions. This instrument will make more difficult to import goods even though exchange may be freely available. Import restrictions may be in the form of tariff, prohibitions on imports of certain goods and quotas and import licensing systems which limit the total amount of imports.

Changes in foreign exchange rate is another method to solve balance of payments crisis. Several factors make the exchange rate an important instrument in achieving external balance. First, there is a direct relationship between the exchange rate and the domestic price of traded goods in a small open economy. Specifically, for a country facing a given world price of traded goods, the domestic price of traded goods is simply the world price adjusted for changes in the domestic currency value of foreign exchange, so that an exchange rate devaluation has the immediate effect of raising the relative price of traded to nontraded goods.

Second, an exchange rate change has a pervasive effect on the real cost of domestic factors of production, which determines the

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[5] B. K. Chaudhuri, Finance of Foreign Trade and Foreign Exchange, Himalaya Publishing House, Bombay, 1982. page 6

[6] B. K. Chaudhuri, Ibid., page 50

competitiveness of a country's non-oil traded goods sector. The increase in the traded goods price raises the general price level, which reduces the real value of given nominal wages.

Finally, the increase in the price level resulting from a devaluation reduces the real value of private sector liquidity, unless the monetary authority undertakes an offsetting increase in the money supply.

The impact of unstable foreign exchange rate has far-reaching repercussions in the economy of a country. Maintenance of domestic price stability and a fixed realistic foreign exchange rate is most important prerequisite for achieving the maximum rate of sustained economic growth. This means that rapidly rising prices and frequently fluctuating foreign exchange rate adversely affect the rate of economic growth in the underdeveloped countries. This phenomenon discourages domestic saving, reduce the inflow of foreign capital and makes difficult to allocate the scarce resources optimally which would finally lead in retarding the process of capital accumulation.

Maintaining foreign exchange rate artificially at a high level has also a negative impact. Due to the unrealistically high foreign exchange rates, when compared with the free market rates that are determined on the basis of supply and demand, the governments of underdeveloped countries resort to the various types of foreign exchange controls and import licensing that discourages the development of import trade while encouraging speculative and smuggling activities in this sphere.

Furthermore, overvalued exchange rate discourages exports. This may happen in two ways. First, an overvalued exchange rate makes the foreign currency prices of a country's exports too high, which results in curbing demand for export. Secondly, an overvalued exchange rate discourages the domestic supply of exports by inducing a shift in the domestic production pattern from exports to non-traded goods. Thus, production of exportable goods will be reduced because they will go to the domestic market rather than foreign markets. As a combined result, the growth of exports will be retarded. In a problem like this even setting up of government export promotion councils and export subsidies will not solve the problems. To this effect the following statement by Mahmoud:

> Exchange rate overvaluation by causing distortions hurt African efforts to develop agriculture and industry in several ways. Exchange rate overvaluation raises the cost of local inputs and raw materials. This can reduce

> the competitiveness of local outputs on the world market. It also leads to a dependence on food imports at the expense of local production. Most significantly, in agriculture, a system of over-valued exchange rates serves to depress prices farmers receive for their export crops and can eventually lead to the decline of the export sector. In industry, the system encourages import intensive methods of production since local industry is allowed to import cheap foreign inputs.[7]

Devaluation is a solution in which an overvalued currency is changed at a rate closer to what the free market supply and demand for foreign exchange would dictate. Thus, devaluation is a reduction in a country's official rate of exchange between its own currency and other currencies. Devaluation is also intended to restrict imports by raising the price in domestic currency of all imports, and will give exports a boost by permitting export producers to lower their selling price in foreign exchange without losing income in domestic prices. Thus, as Chaudhuri states,

> Devaluation makes the country's exports cheaper and imports dearer and thereby stops further drains on the country's foreign exchange resources. On the other hand, the extra exports after devaluation may leave a smaller supply of goods for domestic consumption as a result of which incomes may exceed the supply of goods, leading to inflation, i.e. rise in prices, which may eventually offset the benefits of devaluation.[8]

Devaluation has been associated with reduced economic growth and increased unemployment, and, in countries with an active public sector, it has been linked to undermining public sector investment and development strategies. The rise in the cost of living and the redistribution of income that a devaluation entails have also frequently been criticized for shifting the burden of adjustment to the lower-income groups who are least able to afford it. In addition, the initial inflation caused by devaluation may lead into budget deficits, which aggravate inflationary pressures and giving rise to another overvalued rate and need for another adjustment.

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[7] M. I. Mahmoud, "Possible National Strategies to the Balance of Payments in African Countries", Financial Journal, Vol6 N2, 1985. page 20

[8] B. K. Chaudhuri, Op. Cit., page 6

To this effect Payer states that devaluation may also have a negative impact on the economy by raising the inflation rate without sufficiently improving the external payments position, which eventually induces another devaluation and plunges the country into an inflation-cum-devaluation spiral.[9]

Devaluation has other implications for the government budget in African countries. Government is usually the biggest employer and government employees may demand increase in wages and salaries as a result of increase in the prices of consumer goods. However, a significant proportion of the government budget consists of wages and salaries and any additional increase in wages and salaries can therefore substantially increase government budget deficit. Government expenditures on imported capital goods and other imports are also likely to increase. Devaluation may favourably affect income taxes (as a result of the rise in money incomes and the general price level) to ensure that the budget deficit (relative to GDP) is not increased.[10]

However, devaluation does not necessarily result in improvements in a country's negative balance of payments because of the following. The principal objective of devaluation is to reduce the amount of imports due to an increase in the rices of imported goods. However, indispensable imports will continue to be imported even at the new exchange rate. Moreover, consumers may not be willing to buy local products in preference to the imported. Furthermore, domestic producers may not be able to manufacture import competitive products at short notice, and some times may not be able to produce at all. Finally, exporters merely pocket a higher profit at the new exchange rate and do not lower their export prices in response to devaluation. Often the exporter is a foreign-owned corporation and the extra profit will eventually be remitted abroad.

Another alternative method to solve the payment crisis is through deflationary monetary and fiscal policies. A government can reduce its budget deficit either by increasing taxes or decreasing its spending or both. However, since government spending is considered as an important instrument for both socio-economic development and income redistribution in Third World countries, a restraint on these functions in extremely unpopular.

By using deflationary monetary policy a government can limit

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[9] Cheryl Payer, Op. Cit., page

[10] M.I. Mahmoud, Op. Cit., page 33

credit by raising the bank interest rate or the amount of reserves banks must hold against their deposits. Again, this has also its own limitation. Since business depends on domestic sources of credit to finance current operations, shortage of credit is likely to cause unemployment and, if severe, business failures.

Though deflationary fiscal and monetary policies are solutions for external imbalances, they have their own shortcomings. Their consequences may be so damaging that nations consider the price too high to pay for the marginal effect that such policies are likely to bring about on the demand for foreign exchange.

MULTIPLE EXCHANGE RATE SYSTEMS (MERS)

So far, we have discussed the various methods used to correct balance of payments crisis and their short-comings. As a result of the short-comings of these policy instruments, many countries have used the multiple exchange rate systems in lieu of the other alternatives indicated above.

In the immediate post-war period more than fifty countries used the multiple exchange rate system in one form or the other. The multiple exchange rates system was employed first by Germany and then by Chile, Argentina, Brazil, Peru, and others. These countries fixed different exchange rates for imports and exports of different commodities. They even fixed different exchange rates for different classes of imports so that they could earn the maximum possible amount of foreign exchange by curtailing imports and boosting exports.

There are various objectives for employing the system of multiple exchange rates. The benefit of applying such a method is to earn financial revenue or restrict imports, or to protect the domestic market for indigenous industries.

Multiple exchange rate system can be used as a balance of payment instrument. It helps to correct the balance of payment disequilibrium by influencing the supply of and the demand for foreign exchange. To alleviate their pressing balance of payments disequilibrium, many underdeveloped countries set not only different rates for exports and imports but also attach a variety of exchange rates to specific commodities of exports and imports. The exchange rate fixed for imports is generally higher than for exports.

By fixing different rates of exchange for various classes of imports and exports, countries can avoid the effects of the indiscriminate system of devaluation. A partial devaluation for some import items through multiple rates is occasionally favoured over total devaluation. In such a system, imports are divided into different categories and different rates are fixed for each category. This system helps to encourage the import of productive commodities and curtail luxury items specified according to a development plan of a country. To this effect, a favoured rare is set to imports necessary for the productive sector of the economy

while a higher rate is applied to luxury items.[11]

Similarly, multiple import rates may be employed to minimize an increase in the volume of imports and to control the price increase on some imports that can be ascribed to devaluation. Less devalued exchange rates, for example, are applied for some imports useful in the cost of living than luxury items. In the same token, less devalued exchange rates may be applied to intermediate products or raw materials necessary for local industries so that prices rise along the cost structure could be reduced.

It is also a common practice to use a series of exchange rates to a country's exportable items. Exports of certain commodities are encouraged by applying a higher exchange rate while other products essential for domestic consumption are subject to lower rates of exchange.

Where the government is a major importer, differential import rates assist in reducing government expenditure resulting from an increase in the domestic currency cost of imports. Moreover, multiple rates enable a government to control the composition of a country's external trade avoiding corruption that may result from employing exchange controls. Such a system is also used to generate domestic income for government.[12]

Multiple exchange rate serves to minimize inflation through retaining part of exporters' profits by setting a lower rate of exchange on the proceeds of their exports, or levying a tax or duty on transfer payments. Instead of using customs duties and taxes, multiple exchange rate is applied as an alternative to protect indigenous industries from foreign competitors. The domestic market is secured for locally produced goods by imposing a high exchange rate for foreign currencies and when making payments for imports similar to domestically produced goods.

It is also recommended that a country which aims at achieving conflicting ends (for instance, the containment of inflation and the fostering of industrial diversification) uses differentiated exchange rates to meet both objectives at the same time. Such a policy requires employing an appreciated rate to useful imports while encouraging competitiveness with a depreciated rate for transactions related with exports and imports that compete with

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[11] Central Bank of Egypt, "Multiple Exchange Rates (The Egyptian Experience)", FINANCIAL JOURNAL, V.2, N.1, 1981, p9

[12] Cheryl Payer, Op.Cit., p. 18

local industries. The impact of such a method on prices and allocation should be similar to a policy that provides a consumption subsidy to necessary imports, a production subsidy to exports and the imposition of a tariff on imports that compete with local producers.

Another rationale for using multiple rates to avoid inflation is worth mentioning here. Multiple rates may also have monetary effects to solve inflationary problems in an economy. If the revenues or exchange profits generated from a system of multiple rates are sterilized, an important anti-inflationary effect can be achieved. Hence, the multiple rate policy gives a dual effect on easing the balance of payment problem, i.e., it will have a devaluation effect and prevents the monetary expansion due to devaluation is prevented by earmarking in the form of exchange profits. Both the exchange and monetary effects assist in curbing import demand. In addition, if the rare of exchange for exports is stable while the rate for imports is devalued, some of the inflationary outcomes of devaluation may be prevented.

There are various economic and administrative reasons why the multiple exchange rate syster is preferred to taxes and subsidies. Multiple exchange rate as a device for exchange control can be used to payments for invisibles while the role of taxes and duties is restricted to imports and exports.

Furthermore, levying taxes or custom duties on imports and exports may also be difficult due to international agreements. In a country where taxes on exports or duties on imports are difficult to apply for political reasons, or where income taxes are non-existent or insufficient, multiple exchange rate system is favoured as better means of taxation.

The other more important reason for depending on multiple exchange rate system than tax and duties for revenue is that the fiscal policy is usually overburdened with small indirect taxes that generate little revenue.

Multiple exchange rate systems enables a country to restrict the use of scarce foreign exchange for imports and other expenditures by depending on price and cost incentives. The demand for and the supply of exchange are balanced by the rate of foreign exchange rather than by administrative measures. Hence, multiple rates are used as a device for allocating exchange on the basis of willingness to pay the price than on the basis of the capacity to get a license. Multiple rates assist to avoid the arbitrary decisions of exchange rate control authorities who strive to

quantitative restrictions. Thus, since multiple rates reduce interference on consumer's choice and are less arbitrary than licensing, they are preferred to quantitative restrictions.

On the other hand, the preference of multiple exchange rate to taxes and subsidies can be analyzed on the basis of its administrative feasibility and public acceptability. In a country where specific institutions for administering exchange controls and customs are established, multiple rate is less expensive to be handled than taxes and subsidies that need complicated fiscal arrangements. Multiple rates are also favoured than exchange systems based on quantitative controls. Quantitative exchange control demands a comprehensive system of licensing, exchange budgeting and exchange allocation. A system of multiple rate, on the contrary, can be easily administered by a group of few bankers who purchase and sell exchange.

Therefore, we can now summarize the advantages of applying multiple exchange rate system as follows. Multiple exchange rates to the country practicing them lie in the fact that it abandons the need to employ quantitative restrictions and export-import licensing. Moreover, it substitutes a system of rationing the demand by cost or price for rationing of imports by quantitative restrictions on supply. In addition, multiple exchange rate system encourages exports and discourages imports of the country and consequently promises a favourable balance of payments for the country adopting the policy of multiple exchange rates.

However, the use of multiple exchange rate system has its own limitations. Multiple exchange rate system introduce complexity and if either the exchange rates or the commodities that are allowed to be imported or exported at each exchange rate are frequently changed further uncertainty is created. Besides, unless some positive preventive actions are taken inconsistent cross rates are likely to emerge. From the point of view of international economic prosperity, multiple exchange rates result in uneconomic utilization of scarce domestic and world resources.

Decision makers will be less aware of the implicit expenditures and revenues involved than when the relevant items appear in the budget, as is the case with taxes and subsidies. Thus Payer states that, multiple exchange rate system is not so immune to corruption as it may seem; the effectiveness of multiple rates in guiding the economy can be no better than the intelligence with which they are devised and the honesty and efficiency of those

who enforce them.[13]

In so far as multiple exchange rates tend to overvalue the country's currency, they amount to a tax on exports and a subsidy on imports while in the opposite situation they have the effect of a subsidy on exports and a tax on imports. In either case, as a consequence of practicing multiple exchange rates international trade is diverted to unnatural channels.

Furthermore, multiple exchange rates obstruct the optimum utilization of a country's resources and hamper the planned development of a country's economy. They increase the dependence of the country on foreign goods which could have been produced at home.

Finally, apart from causing inefficient use of the limited domestic resources, the system of multiple exchange rates had discriminatory effect on competitors. When a subsidy rate is introduced for exports, it applies only to a limited number of exports. Consequently, only a few competing countries suffer from its hold. This amounts to a kind of unfair competition and discrimination against few selected countries.

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[13] Cheryl Payer, Ibid, p.19

III. EXPERIENCES OF SUB-SAHARAN AFRICAN COUNTRIES

A useful point in assessing the desirability of multiple exchange rate system in to look at the experiences of African countries. This part reviews the conditions under which such a system is undertaken in some Sub-Saharan African countries.

UGANDA

Characteristics of the Uganda Economy

The Ugandan economy is primarily agricultural. Coffee is the principle cash crop, representing about 90 percent of all export earnings. The secondary sector--comprising mining, manufacturing, construction, and utilities--represents less than 10 percent of GDP. About 22 percent of GDP derives from commerce, transport and communication, and miscellaneous services. In 1988 with an estimated population of about 16 million, and total Gross Domestic Product (GDP) of USh 366.4 million, output per head amounted to USh 22900 or about 138 US dollars per annum, which is among the lowest per capita income figures in the world. The table below presents some of the essential information on the Ugandan economy. It will be seen from the table that a high proportion of GDP - very nearly 31 percent - is derived from subsistence activities, and that agriculture alone accounts for well over 50 percent of Monetary GDP. Manufacturing forms about 10 percent of Monetary GDP.

Table 1
Structure of the Economy: 1988

	USh million	percent of GDP
Monetary economy		
Agriculture	121386.3	33.1
Cotton Ginning, Coffee etc.	1945.9	0.5
Forestry, Fishing & hunting	5498.1	1.5
Mining and Quarrying	3.5	-
Manufactured food products	1422.1	0.4
Miscellaneous Manufacturing	21189.0	5.8
Electricity	244.0	-
Construction	5574.5	1.5
Commerce	36452.5	9.9
Transport & Communications	11058.7	3.0
General Government	13217.8	3.6
Miscellaneous services	5104.7	1.4
Rents	13535.0	3.7
Total Monetary Economy	236632.1	64.6
Non-Monetary Economy		
Agriculture	113766.6	31.0
Forestry, Fishing and Hunting	3323.6	0.9
Construction	463.7	0.1
Owner Occupied Dwellings	12248.1	3.3
Total Non-Monetary Economy	129801.9	35.4
Gross Domestic Product	366434.0	100.0
Gross Domestic Product Per Capita	22980.0	-

SOURCE: Uganda, Background to the Budget, 1989-1990.

Evolution of the Exchange Rate of the Ugandan Shilling

The principal objectives of exchange rate policies in Uganda have been to increase production for export, to reduce budget deficit, to counteract the erosion of the Ugandan Shilling by high inflation, to encourage savings and efficient allocation of scarce credit.

Until 1981 the value of the currency, the Ugandan Shilling (USh), was linked to the SDR, and the official rate of exchange in mid 980 was USh 9.7 per SDR (or USh 7.3 per dollar). In June 1981, the Government introduced a package of monetary and fiscal policies, the key element of which was to allow the shilling to float. In August 1982 a two tier exchange rate was introduced. This lasted until June 1984 when the two rates merged at USh 299=$1. Since now, the exchange rate is fixed in terms of the U.S. dollar. Between February 19, 1986 and May 28, 1986, the exchange rate was set at USh 1470 per U.S. dollar; during May 28-August 23, 1986, this rate was revalued to USh 1400 per U.S. dollar and a secondary market rate of USh 5000 per U.S. dollar was established for receipts from nontraditional exports and services, and imports of consumer goods.

In May 1987 a new currency unit was introduced with an effective devaluation of 76 per cent. The Shilling was devalued from 14 USh=1 US$ to 60 USh=1US$. On May 15, 1987 the authorities introduced a currency reform under which one new Uganda Shilling replaced 100 old Shillings.

In July 1988 a further devaluation from 60 Shillings=1US$ to 150 USh=1US dollar was made. In December, 1988 a further devaluation from 150 Shillings = 1US$ to 165 Shillings = 1US$ dollar was made. In March, 1989 the Shilling was devalued from 165 Shillings = 1US$ to 200 Shillings = 1US Dollar.

The main objectives of the above devaluation, particularly the recent ones, were the following. Since the main export item of Uganda is coffee, the government tried to boost production of coffee. As a result, there was a need to pay higher producer prices through devaluation. Furthermore, in order to reduce the

high budget deficits, the Government of Uganda used devaluation as an instrument.

Finally, it was necessary to devalue in order to counteract the erosion of the Uganda Shilling by high inflation. Many factors have contributed to the build up and persistence of serious inflation in Uganda. Shortages of imported consumer goods and the disruption of domestic transport networks, which have limited supplies of domestic foodstuffs to urban areas and large wage increases, particularly in 1984/85 and again in mid-1987 following the devaluation of the shilling and the currency conversion exercise, which increased money incomes are contributing factors. Moreover, the rapid expansion of domestic credit, which has contributed to large increases in the broad money stock and major overruns in budgetary expenditure and a mushrooming of private sector credit for crop financing, miscellaneous agricultural credit, and credit for manufacturing have contributed to inflation. Finally, the devaluation of the Ugandan Shilling has also contributed to inflation.

Uganda relies on trade and payments restrictions. All foreign exchange allocations are controlled administratively, and very little has been made available for private sector transactions.

The current system of administrative allocation of foreign exchange has been in effect since February, 1986. There are no automatic entitlements of foreign exchange for any purpose. Allocations are decided within the framework of a foreign exchange budget. Allocations are given only for imports considered essential. Within sectors, agriculture and industry are accorded the highest priority. Uganda maintains a highly restrictive system of administrative control of foreign exchange allocation and import licensing.

Uganda quote two separate exchange rates based on an official market and a commercial market. The official market is generally for transactions relating to essential imports, and all official transactions. Specified traditional export transactions are also made at the official rate. The rest of the transactions are carried out through the commercial market.

Transaction with traditional exports, official loans and essential imports are conducted at the official exchange rate. A weekly auction held by the Central Bank determines the exchange rate of the second market where transactions relating to all other imports and invisibles take place. In addition, there is a service charge on some exchange transaction.

T A B L E 2

Official Annual Average Exchange rates: 1981-1989
(New Uganda Shillings per US Dollar)

	Window One	Window Two	Auction	Fixed Priority	Market	Ordinary	SIP[1]
1981	-	-	0.501	-	-	-	-
1982	0.940	2.584	-	-	-	-	-
1983	1.539	2.764	-	-	-	-	-
1984[2]	2.704	3.132	4.233	-	-	-	-
1985	-	-	6.744	-	-	-	-
1986	-	-	-	14.266	50.0	-	-
1987	-	-	40.833	-	-	-	-
1988	-	-	106.833	-	-	-	-
1989[3]	-	-	-	-	210.0	400.0	

SOURCE: Uganda, Background to the Budget, 1989-1990

[1] Special Programme 2
[2] Windows Unified in June 1984
[3] From January upto July

As can be seen from the above table, Uganda used two rates for 1982, 1983, 1984, 1986 and 1989. The above-mentioned review and the table above indicate that for many years and in particular in 1989, Uganda adopted a system which leads to the existence of multiple exchange rates.

ZAMBIA
THE ECONOMY

Zambia is a small developing country and a non-oil mineral exporter. As shown in the Table below the share of agriculture in total GDP was 15.1 per cent in 1987. The mining sector is of great importance in Zambia. Although it accounts for only 15.9 per cent of GDP, exports of copper represent about 85 per cent of foreign exchange earnings. Manufacturing contributed about one-fourth of GDP in 1987. Zambia is heavily dependent on the export of copper, which has for many years played a dominant role in the economy. The share of minerals in exports is over 90 per cent and the ratio of exports to Gross Domestic Product has been around 30 per cent. Copper is the most important export item, accounting for 84 per cent of the total export earnings. In an economy, such as this, which depend upon one mineral commodity, a fall in the world price will affect the economy tremendously. This was the situation which aggravate Zambia's balance of payment crisis.

TABLE 3
STRUCTURE OF THE ECONOMY: 1987

	Zambian Kwacha million	per cent of GDP at C.P.
Agriculture	4694.7	15.1
Mining and quarrying	4934.1	15.9
Manufacturing	8190.5	26.4
Commerce	4982.8	16.1
Financial Services	3079.5	9.9
Transport & Communications	1413.4	4.6
Community, Social & Personal Services	2631.1	8.5
Others	1074.3	3.5
GDP at current prices	31000.4	100.0

EVOLUTION OF THE EXCHANGE RATE OF THE ZAMBIAN KWACHA

On January 16, 1968 a new currency unit the Kwacha replaced the Zambian pound which ceased to be legal tender on January 13, 1974. The Kwacha was equivalent to 10 Shillings in the previous currency. Zambia's currency, the Kwacha, has been successfully pegged to the pound sterling, the US dollar and, more recently, to the SDR.

In 1973 the Kwacha was de-linked from pound sterling and linked to the US dollar. In July, 1976, the Government decided first to de-link the Kwacha from the dollar and link it instead to the SDR, and, secondly, adjusted the Kwacha rate by 20 per cent, thus bringing it back to the level it should have been had it not been linked to the US dollar.

The problems confronting Zambia stemmed in larger part from the dependence of the economy's output, expert earnings, and government revenues on the production of copper--a dependence which makes Zambia highly vulnerable to fluctuations in the external terms of trade. Copper prices rose strongly in the 1973-74 commodity boom, with consequent effects on economic activity and the government's revenue position; but the boom was short-lived. Copper prices fell 40 per cent in 1975, while at the same time import prices continued to rise. Together with increases in transportation costs and wages, these developments led to serious financial difficulties for the mining companies in 1975-76, which threatened not only hoped-for expansion but also the ability to utilize existing capacity efficiently.

Zambia's external position deteriorated sharply, with the overall balance of payments moving from a small surplus at the height of the copper boom to a deficit of SDR 320 million (equivalent to 16 per cent of GDP) in 1975, despite high levels of external borrowing by both the government and the mining companies. External payments arrears began to accumulate, and trade and payments restrictions were intensified. Contemporaneously, the government was experiencing severe difficulties in adjusting fiscal and monetary policies to rapidly changing circumstances. Government revenues fell owing to the lower value of copper exports, but expenditure policies aimed at insulating government employees and other consumers from the direct and indirect effects of imported price inflation raised the central government's fiscal deficit as a proportion of GDP to nearly 20 per cent. The enlarged deficit was largely financed by an accelerating rate of domestic credit expansion which rose to 71 per cent in 1975. Pricing policies designed to protect urban consumers resulted in relatively moderate rates of recorded inflation, but this was achieved at

substantial budgetary cost and to a certain extent at the expense of domestic producers of agricultural goods, who suffered from inadequate incentives owing to the restraint of agricultural prices. The external shock (the terms of trade declined by 50 per cent in 1975), combined with domestic policy inadequacies and structural weaknesses, presented Zambia with a severe problem of adjustment.

The devaluation of the Kwacha by 20 per cent took place in July 1976 and was part of a broader stabilization program designed to improve supply conditions and to restrain domestic demand in the economy. It was envisaged that the devaluation would be fully reflected in domestic prices and non-wage costs, allowing an amelioration of the copper industry's profitability and adjustments in agricultural and other producer prices. Further, direct and indirect consumer subsidies were to be reduced. With changes in the level and structure of domestic prices, it was expected that agricultural and nontraditional export production would be encouraged, thereby achieving modest gains in the direction of a more diversified economy. However, the authorities made no significant changes in the structure of interest rates, which remained negative in real terms.

The program also envisaged a reversal of the expansionary demand management and incomes policies that had been pursued during 1975. Public sector wages were to be frozen in 1976, a policy also designed to moderate wage awards in other sectors. A reduction of the fiscal deficit to 10 per cent of GDP was targeted, to be achieved mainly by decreasing current expenditures. Policies to slow credit expansion to the private sector included changes in the reserves and liquid asset requirements of banks. With these changes in fiscal and monetary policies, a substantial reduction in the current account deficit was projected. Considerable uncertainty existed as to Zambia's access to external capital, but after a planned reduction in external arrears, Zambia was expected to be able to increase its foreign borrowing. In that event, some relaxation of trade and payments restrictions was envisaged.

The stabilization program was temporarily successful in improving the profitability of the mining companies and the internal terms of trade faced by agricultural producers. A brief surge in export receipts from copper, due to both price and volume factors, and a fall of import volume caused by stringent import restrictions brought about a substantial reduction in the current account deficit during 1976. However, the supply of agricultural commodities did not increase in the 1976 and 1977 crop years, owing to poor weather conditions and to the fact that producer prices were not raised sufficiently to reflect the devaluation and

subsequent domestic inflation. Producer prices for all major agricultural products were held at their pre-devaluation levels during the 1976/77 crop year. Producer prices were raised in 1977/78 by amounts ranging from 8 per cent for maize to 26.5 per cent for soya beans. However, since the inflation rate as measured by the consumer price index was nearly 20 per cent in 1976 and 1977 and 16 per cent in 1978, the rise in administered agricultural prices was not sufficient to provide increased producer incentives.

Efforts to increase tax revenue from mining were successful but, despite successful restraint of public sector wages, delays and difficulties encountered in implementing reductions in current expenditures meant that the overall fiscal deficit remained excessive, at 14 per cent of GDP. Further efforts were made to adjust real domestic demand in 1977, but fiscal policy remained too expansionary. Consumer subsidies and claims of parastatals on government resources, in part in response to inadequate pricing policies, continued to represent difficult social and economic problems for the authorities. Overall real domestic demand declined in 1977, but was insufficient to bring about a reduction in either the rate of increase in the consumer price index or an improvement in the current account deficit. As the terms of trade declined again and despite a further fall in import volume, the current account deficit widened.

In 1978, external developments continued to be unfavourable for Zambia, when the terms of trade declined again, aggravating still further the serious internal and external imbalances. The financial problems of the mining companies again become acute, a situation made worse by transportation bottlenecks on the major export route. Strict import controls and payments restrictions remained in force, contributing to inflation and restricting economic activity in domestic industries heavily dependent on imported inputs. The Kwacha was devalued again in March 1978 by 10 per cent in order to assist the mining companies and to encourage other exports and import substitution. Zambia's economic problems remained severe: real GNP stagnated as agricultural production and non-mining exports recorded little improvement, fiscal policy difficulties continued, the rate of inflation remained high, and problems with external arrears continued.

In 1981, the Government undertook some policy changes. This included the acceptance of a range of stabilization measures by the International Monetary Fund. This was not successful and led to the cancellation of the programme.

The Kwacha was devalued in January 1983 by 20 per cent against the SDR. In July 1983, the Kwacha was pegged to a basket of currencies instead of the SDR. The economic situation has reached

crisis in 1985. There was a negative GDP growth, severe inflation, industrial capacity was under utilized, a sharp deterioration of terms of trade, depletion of foreign reserves and growing external indebtedness. Against this background, economic reforms were introduced.

As part of the reforms, on October 4. 1985 a new system for determining the exchange rate of the Kwacha was effected. The new arrangement centered on the auctioning of the foreign exchange on a weekly basis. Objectives of the new exchange rate regimes were to ensure that the exchange rate is fully responsive to changes in the demand for and supply of foreign exchange and to provide foreign exchange in a timely manner; the promotion of a higher volume of production and broader range of exports; reducing the administrative mechanisms in the allocation of foreign exchange; and the attraction of foreign exchange which is held outside the banks into the banking system.

The auction system began to have a negative impact on levels of domestic inflation by the end of 1986. The auction determined rate for Kwacha continued to fall sharply. The auction system was suspended in January 1987. The exchange rate regime adopted in January 1987 allowed the Kwacha to float within a band of K9 to K12.5 per US dollar. The floating exchange rate policy was aimed at correcting the perceived overvaluation of the Kwacha which worked to perpetuate the imbalance in the external balance of the economy and to distort an efficient allocation on the scarce resources domestically.

A dual exchange rate system was introduced in late March 1987, comprising an official rate that was to move within a band and an auction determined rate. The Government procurement of medicine and educational materials, Government debt service, and proceeds from external loans and grants were to be conducted at the official exchange rate. All transactions were to be effected at the auction rate. On May 1, 1987 a fixed exchange rate system with the rate set at K8 per US dollar was introduced. On November 9, 1988, the Kwacha was devalued from k8 per U.S. dollar to k10 per U.S. dollar and pegged to the SDR (k 13.4115 per SDR). On July 1, 1989 another devaluation to k 19.9429 per SDR was made.

NIGERIA

THE ECONOMY

In Nigeria, the primary sector (petroleum plus agriculture and related activities) accounts for about 58 per cent of GDP in 1987. Agriculture, together with animal husbandry, forestry and fishing, constitutes the most important economic sector in Nigeria. It accounts for about 30 per cent GDP and provides employment for the major section of the population, the bulk of which is engaged in subsistence agriculture. Manufacturing and handicraft activities account for about 10 per cent of GDP and employ about 18 per cent of the active labour force. The share of construction and transportation sector in GDP was 6.1 per cent in 1987.

T A B L E 4

GDP by industrial origin at current prices, 1987
in million of Naira

	1987	% of GDP
Primary Production	63649	58.0
Agriculture	32710	29.8
Mining and quarrying	30939	28.2
Secondary Production	15732	14.3
Manufacturing	10220	9.3
Construction	2484	2.3
Housing	2589	2.4
Utilities	439	0.4
Services	30305	27.6
Transport and Communications	4218	3.8
Wholesale and Retail trade	16153	14.7
Government Services	4987	4.6
Others	4947	4.5
GDP at factor cost	109686	100.0

SOURCE: IMF; Nigeria- Recent Economic Developments Aug. 18, 1989

THE STRUCTURE OF THE FOREIGN EXCHANGE MARKET IN NIGERIA

Nigeria had introduced structural adjustment programme (SAP). The basic points of SAP were to alter and restructure Nigeria's patterns of consumption and production. To achieve this, elimination of price distortions and the economy's heavy dependence upon the export of crude oil and the imports of consumer and producer goods were necessary. Other objectives of SAP were, the maintenance of fiscal and balance of payment equilibrium, laying the basis of sustainable and non-inflationary or at least minimal inflationary growth and reducing the dominance of the public sector.

The strategies used to carry out these policies were the adoption of a realistic exchange rate policy, liberalization of the external trade and payments system and loosening and reduction of complicated price controls.

Thus, in order to ease the considerable pressures on the balance of payments by cutting back the demand for foreign exchange to available supply, was the introduction of the Second Tier Foreign Exchange Market (SFEM) on Sept. 26, 1986. The country's single official exchange market was changed to what was known as the foreign exchange market (FEM).

The Foreign Exchange Market (FEM) is the official market at which foreign exchange may legitimately be bought or sold in Nigeria. At its inception, the FEM covered all foreign exchange transactions with the exception of those relating to external debt services, contributions to international organizations, transfers to Nigeria's missions abroad and all transactions governed by the transitional provisions. The system consisted of a first tier which continued to have an administered rate covering external debt services, etc., and a second tier foreign exchange market (SFEM) covering all other transactions. The SFEM included a foreign exchange auction conducted by the central bank and an interbank market. However, with the convergence of the first and second tier market rates early in July 1987, one rate (the FEM rate) applies for all transactions.

TABLE 5
Annual Average Exchange Rates of Naira per US $

	Auction rate	Interbank rate	Official rate
1987	3.9830	4.1773	3.2012[1]
1988	4.5182	5.5084	-
1989	-	-	7.3430[2]

Source: IMF: Nigeria - Recent Economic Dev't, August 18, 1989

[1]The official exchange rate for certain transactions was merged with the auction rate on July 2, 1987

[2]From January to June, 1989

The monetary and credit policy in 1987, which was designed within the context of the ongoing SAP to curb excessive demand pressures and stabilize the economy, has had some salutary impact during the year.

The implementation of the SAP helped to resolve the problems associated with Naira over-valuation import and export licensing and foreign exchange rationing. However, the pressure on the Naira exchange rate and domestic prices persisted while unemployment remained unacceptably high - and hence a further depreciation of the rate by about 20 percent in 1987.

It is against the background of the problems highlighted above and the need to consolidate the gains already made under the SAP that the monetary and credit policy for 1988 has been formulated. Specifically, the objectives of the monetary and credit policy were the stimulation of growth in national output, raising the level of employment in th economy, the promotion of resources, the moderation of inflation rate and improvement in the balance of payments positions. On January 9, 1989 a new unified exchange system replacing the two-tier foreign exchange market was introduced and the rate was determined at Naira 6.87 per U.S. dollar.

III. MULTIPLE EXCHANGE RATES SYSTEM IN THE CONTEXT OF AAF-SAP

The African Alternative Framework to Structural Adjustment Programmes for Socio-Economic Recovery and Transformation is a broad and flexible framework that governments can use in designing their own individual programmes. It outlines general policy directions that seek to incorporate more immediate adjustment measures with the process of transforming structures of Africa's economies, a path of "adjustment with transformation". Among the major policy directions outlined in AAF-SAP are the greater and more efficient domestic resource mobilization and lessening import dependence. These policy directions need the use of a number of policy instruments and measures for achieving the goals of adjustment with transformation. Thus, in Africa, the use of Multiple Exchange rate system, which is actually working indirectly in some countries, must be applied for purposes of resource transfers, resource mobilization and reversal of capital fight and ensuring availability of essential imports. The application of this system encourages capital inflows, discourages capital flight, improves the balance of payments.

Some of these proclaimed advantages of multiple exchange rates have been realized in practice. The rates have at times been effective as an anti-inflationary tool. In many instances they have helped to offset the price and income effects accompanying inflation. They have often served to hold down a rise in exporters' incomes in periods of export booms and to check increases in key prices in the domestic economy, which are important either in the cost of living or in the cost of production. Accordingly, they have reduced the cumulative effects of inflation.

Multiple rates have also been used successfully during a transition from one exchange system to another. Where exchange devaluation is necessary but is difficult to effect in one step, multiple rates have sometimes been introduced as a prelude to comprehensive devaluation. The use of a series of steps rather than a single step toward devaluation has enabled the economy to adjust to exchange depreciation in stages. Temporary use of multiple rates has also allowed some experimentation in finding the optimum level for a new fixed rate of exchange.

However, in some countries, multiple exchange rates might not serve to hold inflation in check. In this case, much, of course, depends on the nature of the monetary and fiscal policies pursued. If such policies are expansionary and protracted inflation ensues, multiple rates devices usually prove to be unsatisfactory. In such

2situations multiple rates cannot be expected to counteract deep-seated economic maladjustments.

Multiple exchange rates tend to have considerable appeal, especially for developing countries. They are expected to perform certain economic functions which cannot easily be performed by quantitative restrictions, or a single exchange rate. In many instances, developing countries cannot (for political or institutional reasons) introduce adequate taxation of exporters, in the form of either commodity taxes or income taxes or are not pursuing relatively stable domestic monetary policies. In such circumstances, multiple exchange rates have fewer disadvantages than a unitary rate - fixed or fluctuating - and a system of quantitative restrictions. Thus, multiple rates appear both to restrain balance of payments pressures and to serve as tax and subsidy devices.

As already stated, the principle objectives of multiple rates are taxing a major export, restraining imports of ceratin commodities, raising revenue, alleviating inflationary pressures, stimulation minor exports and isolation capital movements from trade transactions. In order to achieve these objectives, the fulfillment of certain conditions are necessary. There must be a continued maintenance of an exchange system with only a few rates rather than a system with many rates (i.E. a simple rather than a complex system). Moreover, sufficient adjustments in th system are necessary in order to keep at realistic levels the exchange rates applicable to most exports and imports. Finally, multiple rates require a reasonable amount of domestic monetary stability.

However, in the absence of these conditions, multiple exchange rates may give rise to many problems. Under conditions of inflation, even more unfavourble effects of multiple rates system may be noted. These may include discouragement of basic export industries through maintenance of penalty export rates at overvalued levels; insufficient simulation of new export industries even where there are special rates for minor exports; distortions in domestic production and investment from multiple exchange system and rigidity of the rate structure so that overvalued rates emerge or, alternatively, the country tends to meet balance of payments difficulties by depreciating the rate structure instead of adopting appropriate domestic policies.

A review of the exchange rate system in the three Sub-Saharan African countries shows that there has been a practice which leads to multiple exchange rates. Indeed, multiple rates exist on a de facto basis in most African countries. Hence, multiple exchange rates should be adopted formally so as to ensure essential imports, discourage capital flight and encourage capital inflows, especially form nationals living abroad.

P A R T B

I. DIFFERENTIAL INTEREST RATES POLICY (DIRP)

The principal objective of monetary policy is to maintain a level of spending sufficient to keep resources fully employed while avoiding rapid changes in the price level and preserving external balances. If a policy is to influence spending decisions in this manner, it should be designed to regulate the overall availability and cost of credit; to influence decisions regarding the holding or disposing of liquid assets; to affect future expectations about each of these factors; and to ensure that the monetary system meets the needs of savers and borrowers in an efficient and flexible manner.

The need for monetary policy to regulate the supply of credit and to influence holders of liquid assets arises from the fact that some entities in the economy spend less than they earn while for other units expenditure will exceed income in the same period. The latter, known as excess spenders or deficit units, have a deficit which may be financed in a number of ways. They can borrow, run down existing cash balances, convert other liquid financial assets into cash, realize securities or persuade their debtors to repay debts. On the other hand, surplus units run a surplus which enables then to build up their cash balances, accumulate liquid assets and securities and repay debts. The cost of this financing by the borrower or the return obtained by the lender, is the interest rate. Hence, monetary policy is concerned not just with the volume of financing, but also with its cost.

Various theoretical arguments are advanced by different schools of thought regarding the role of interest rates. The rate of interest in the classical analysis is determined by the real forces of saving supply and investment demand. Money-its supply and/or demand-has nothing to do with the determination of the rate of interest. The supply of money enters the classical theoretical economic system as a determinant of only the absolute price level of output and does not influence the rate of interest which remains a real variable. Thus, under the classical assumption of full employment, the real rate of interest determines the equality between savings and investment. Money played a passive role in the classical model, since its sole function was to determine the general price level at which transactions of goods will take place and that the quantity of money demanded therefore depended only on

transactions and income.[14]

The Keynesian interest rate theory does not, however, overlook the possibility of changes in the supply of money influencing the rate of interest which in turn might affect the volume of aggregate investment spending and consequently the level of aggregate demand, output and employment in the economy. According to Keynes, interest is purely a monetary phenomenon being determined by the demand for and supply of money. Keynes maintained that equilibrium between savings and investment brought about through changes in income and output and not via the rate of interest which closely related to monetary factors. According to him, rate of interest is determined by the demand for and supply of money, the latter assumed to be fixed in the short-run and thereby insensitive to variations in the interest rate.[15]

The Keynesians and Neo-classical theories are formulated for developed economies with advanced and integrated capital markets and, therefore not suitable for application to the economic and financial conditions of less developed economies.

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[14] Y. S. El-Nil, "Some Important Aspects of The Structures and Role of Interest Rates in Africa", Financial Journal, Vol.7,N1, 1986. page 3

[15] Ibid, page 3

INTEREST RATE POLICIES AND ECONOMIC GROWTH

Interest rates can have a substantial influence on the rate and pattern of economic growth by influencing the volume and productivity of investment as well as the volume and disposition of saving. This is especially true for countries where financial markets are relatively well developed or where private investment constitutes a significant share of total investment. Even in countries with less developed financial markets or in those where investment is overwhelmingly the responsibility of the public sector, interest rates may have a significant effect on the mobilization of household savings and on investment decisions.

Interest rates perform several important functions. On the demand side, interest rates affect the magnitude of aggregate demand, on the supply side, they influence the volume and quality of investment and thus the growth of output. As the reward for accumulating financial assets and postponing current consumption, interest rates influence the willingness to save currently earned income. As an element of the cost of capital, interest rates influence the demand for and allocation of borrowed funds. As the return on domestic financial assets, domestic interest rates, together with the rate of return on foreign financial assets, expected changes in the exchange rate, and the expected rate of inflation, determine the allocation of the public's wealth (accumulated savings) among domestic financial assets, foreign financial assets, and goods that are held as inflation hedges.

A development strategy which relies on financial savings as a major source of investment finance requires price or non-price incentives in order to stimulate financial saving and, where relevant, capital inflows. Thus, savings can be more effectively mobilized by offering savers an attractive incentive in the form of reasonably positive rate of interest. When interest rates are low, individuals reduce their savings and effective mobilization and allocation of savings will be distorted. In Africa, usually, interest rate and the growth of saving are poorly correlated. A number of reasons have contributed to this. The principal one is the imperfect nature of capital market in the continent. The other explanation is that in most low-income societies, it is consumption that is the residual rather than savings because most people save for specific long term objectives and therefore less concerned with interest rates.

However, while an increase in interest rates may stimulate saving by making future consumption less expensive relative to current consumption, it may also tend to reduce saving by lowering the amount of present saving necessary to buy a given amount of future consumption.

Interest rates influence the quantity of fixed investment through their influence on both the volume of total investment and the allocation of that between fixed capital formation and inventory accumulation.

In developing countries a rise in interest rates would reduce the level of desired investment by raising the cost of financing certain investments above their expected rates of return. However, expected rates of return are influenced by the attractiveness of the general economic environment.

Expected returns to investment projects may be negatively affected by a policy of maintaining interest rates that are low relative to inflation. When interest rates are low relative to the prevailing rate of inflation, firms will find it profitable to borrow, or use their internally generated resources, not only for investment purposes but also for imported goods, real estate and foreign currency deposits. An increase in interest rates is likely to induce firms to economize on their use of borrowing for working capital.

It is difficult, however, to assess empirically the significance of interest rates as a determinant of investment expenditures, because of the substitution of alternative mechanisms to raise funds for private investment when the regular channels become inoperative.

Savings might be generated through forced saving by which the inflationary process resulting from increased aggregate demand brings about a redistribution of real income from low savers to high savers. Furthermore, under financial repression there is a tendency for various forms of quasi-financial intermediation such as, unofficial credit markets and self-financed investment to develop. For countries with access to international capital markets, another source of additional financing is foreign borrowing. Finally, an increased investment demand can be financed through an increase in government saving. There are a number of ways in which government saving can be raised. These include, increasing tax effort, reducing non-investment expenditures, and raising the prices of goods and services provided by the public sector. It is thus in some circumstances possible to finance additional investment demand without an increase in interest rates.

There are several reasons why a policy of maintaining low interest rates relative to the rate of inflation tends to lower the productivity of investment. Usually, selective credit arrangements accompany such interest rate policies as an

administrative means of rationing scarce financial resources. For this purpose, identifying priority sectors and controlling the end-use of funds allocated to them is crucial. However, it is not easy or even possible to identify correctly the priority sectors. On the one hand, there is a lack of reliable data on many important economic activities and the existing structure of relative prices, both within the domestic sector and between the domestic and the foreign sectors, becomes highly distorted as a result of widespread use of regulations and controls. On the other hand, predictions regarding the future development in primary as well as manufactured goods' prices, exchange rates, and international interest rates are subject to substantial uncertainties. Moreover, there is a strong tendency by the government to include itself and all public sector activities in the priority category [illegible] the economic justification for doing so is slender or non-existent.

A policy of low interest rates related to the expected rate of price increase also tends to reduce the necessity for careful evaluation of projects by enterprises and the economical use of resources in their implementation. Well-established firms enjoying personal connections or risk averting banks would tend to favoured over smaller or newer borrowers, regardless of the rates of return on the respective investment. Indeed, it is such considerations that in part motivate governments to interfere in the process of allocating credit.

Whenever the cost credit is below the rate of inflation, it will be profitable for businesses to use their credit facilities to carry large inventories of raw materials, intermediate goods and finished products. These transfers of financial resources into inflation hedges further aggravate the scarcity of credit for productive investment and add to inflationary pressures and waste scarce foreign exchange resources.

Policies that lead to sub-equilibrium interest rates, especially when accompanied by a policy of maintaining high real wages, result in a bias in investment in favour of capital intensive techniques. Capital intensive techniques of production general require large amounts of working capital and foreign exchange, the demand for which aggravates existing shortages of both credit and foreign exchange.

Although the primary impact of interest rates is on the financial sector, interest rates, like wages and exchange rates also exert a substantial influence on aggregate output, employment, real investment, and other real economic aggregates.

Government policies on interest rates thus have important

implications for the conduct of demand management policies. The levels and structure of interest rates affect the ability of the central bank to maintain control over the rate of domestic credit expansion, influence public sector revenues and expenditures, and have a significant effect on the balance of payments. As a result, the interest rate policies chosen by the authorities determine to a considerable degree the appropriate stance of other demand management policies.

INTEREST RATE POLICIES IN DEVELOPING COUNTRIES

The importance of interest rates for economic decision making varies among developing countries because of differences in the development of their financial markets, the degree of separation of saving and investment decisions, and the freedom permitted to capital movements in and out of the country. Thus, interest rates play a less crucial role in countries with large nonmonetized sectors than in highly monetized economies, and have less direct impact in centrally planned than in market-oriented economies.

On the whole, the effectiveness of an interest rate policy in a particular country depends on several factors, such as, savings habit, extent of monetization and banking services, availability of alternative financial assets, inflation, size of government borrowing and the role of foreign capital. Since these factors are divergent among countries, it would therefore be quite logical to expect differences to arise in different countries in the intensity and use of interest policy and the degree of its success.[15]

In market-oriented economies, where most saving and investment decisions are taken separately, changes in interest rates and the general price level in response to disequilibria between saving and investment or between demands for and supplies of financial assets are instrumental in restoring equilibrium, provided that the institutional environment permits such changes. The equilibrium interest rate, corrected for the expected rate of inflation is equal both to the marginal rate at which lenders are willing to exchange future for present consumption and to the real marginal rate of return expected on investment opportunities available to borrowers. If these rates are positive, it follows that the equilibrium interest rate must not be less than the expected rate of inflation.

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[15] Y. S. El-Nil, Op. Cit., page 38

In planned economies, where a large part of saving and investment decisions are made according to plan, rates of interest as such have no direct influence on these decisions. But planners, in order to allocate scarce resources efficiently, would in fact need to take into account both the rates of return on different investments and social cost of funds used to finance them.

In most developing countries, in particular African countries, interest rates are determined administratively, typically through legally imposed ceilings on lending and deposit rates. In many of these countries, official control over interest rates is exercised simply by virtue of the fact that all banks, or the largest banks, are nationalized and the influence of the government on their activities is often powerful.

Interest rates are controlled in developing countries because the financial markets in these countries suffer from serious imperfections. Usually, financial markets are very thin and dominated by one or two banks that exercise monopolistic control over interest rates and credit allocation.

Another important motive for controlling interest rates in developing countries is related to the existence of an extensive set of other controls, notably over investment, production, prices, foreign exchange transactions and foreign trade. It should be noted that these controls must be taken into account when interest rate policies are being formulated.

While the authorities in most developing countries choose to control and regulate interest rates closely, the manner in which these controls and regulations are exercised and, particularly, the level at which interest rates are set differ significantly

In some countries interest rates are administered in a flexible manner in an attempt to maintain market related interest rates that follow more or less closely the movements of interest rates that would produced by the forces of supply and demand. In others, however, the administration of interest rate policy lacks this flexibility, and, over time, large divergence between administered and market rates emerge.

In Asian and Latin America developing countries administered interest rates generally follow the movements of rates that would be produced by market forces. In a number of others, however, real interest rates-nominal interest rates corrected for expected price increase-are often negative, sometimes by a substantial margin. Negative real deposit rates signify that, in general, physical assets earn a higher rate of return than do saving accounts, and

a negative real loan rates mean that it is profitable to borrow even where there is very low rate of return on the use to which the borrowed funds are put.

Rationales given for maintaining negative real interest rates in these countries range from keeping down the cost of servicing the public sector's debt, or of investment, to avoiding the consequences of other policies, such as, maintaining a large fiscal deficit and limiting private credit expansion, on interest rates, investment, and growth, and to subsidizing disadvantaged economic groups or regions. The excess demand for credit generated by these low real rates if frequently associated with selective credit policies helps to channel available funds to key industries and sectors.

Interest rates are not only subject to ceilings, but also maintained below th equilibrium rates through the implementation of controls on credit and the provision of concessionary finance by the government. Thus, interest rates are not market determined, and do not reflect the scarcity of credit and capital in these countries. The demand for credit at the prevailing interest rates in the organized money market often remains continuously unsatisfied, particularly in the agricultural sector and small businesses. Hence, economic activity in most cases is constrained more by the availability and to a lesser extent by the cost of credit. Credit rationing is likely to be the most powerful one in developing countries owing to the fact that interest rates are relatively inoperative.

Interest rates are used in Africa to achieve a less expensive government borrowing, a greater mobilization of domestic savings, economic growth by fostering investment, monetary and price stability, attraction of foreign capital and the mitigation of capital flight, minimization of inefficiency in the allocation of resources and financial promotion.[17]

Most of the financial and monetary systems of African countries have been characterized by an imposing public sector borrowing requirement, low savings and investment in relation to GDP, mounting inflationary pressures and dual financial markets. Most African governments borrow from their banking systems in order to meet budgetary short-falls arising mainly from a constant

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[17] Y. S. El-Nil, Ibid., page 38

revenue income and fastly expanding recurrent expenditures.[18] However, government borrowing to launch unproductive schemes, or in support of public sector's commercial enterprises, should not qualify for preferential interest rates simply because of its allocative inefficiency.[19]

In general, the interest rate structure that prevails in these countries has largely been shaped by government regulations and legislation in the banking and monetary field. Governments fix the interest rate at low levels and due to the persistence of high inflation and the infrequency of changing the interest rates, negative real interest rates have become the order of the day.

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[18] Ibid.

[19] Y. S. El-Nil, Ibid., page 41

DIFFERENTIAL INTEREST RATES

As mentioned before, interest rate serves as an instrument in the allocation of credits and in promoting saving and investment. Hence, countries apply different interest rates for different purposes.

In a transitional stage of socialist economic development where the production relation is in favour of the private sector, socialization of economic activities is taken as a primary objective. Thus, interest rates are differentiated depending upon the degree of socialization of the various sectors of the economy. Therefore, under this principle, preferential treatment is made to collective and state sectors against the private sector. The private sector will be charged relatively higher interest rate without, however, dwarfing those activities which potentially contribute to the social and economic development.

To the extent that interest rates serve as one of the instruments in the allocation of credits, those sectors of the economy which on real and potential terms contribute to the fulfillment of domestic consumption needs, generate higher income, serve as a source of foreign exchange earning, increase labour absorption capacity, and in general enhance the capacity of one sector to the development of the other and help eliminate sectoral imbalances should be favoured in interest rates.

Strategically important commodities which serve as a better means of production should be favoured in interest rates. In this respect, special consideration may be given for such inputs as fertilizers, improved seeds and farm implements which increase agricultural production and commodities which enhance export diversification.

In most African countries, interest rates of some of the specialized financial institutions are highly subsidized by governments. Central bank credit to agricultural banks is extended at very low interest rates. Usually, for agricultural activities credit is given at preferential rate while industrial and housing interest rates are relatively higher than other rates. But in some countries, where the government has structured and encourages housing programmes for low income groups, interest rates on housing loans are subsidized and below commercial banks' lending rates. Even, in some countries, a preferential treatment is made depending on whether the construction of a house is undertaken privately or through housing cooperatives.

In addition the application of a wide range of special practices and arrangements in African countries, such as interest charges on deposits, commissions, interest payments on demand deposits clearly show that differential interest rate policy is practiced.

II. EXPERIENCES OF SUB-SAHARAN AFRICAN COUNTRIES

INTEREST RATES IN UGANDA

Interest rates have been revised downward or upwards on the basis of the economic environment in Uganda. 1968 was a period immediately after the currency reform. Most prices were at the time falling, and it was feared then that high interest rates may choke off investment and discourage borrowing. It was, therefore, decided to adjust interest rates downward. Accordingly, saving rates range from 1% to 2% per cent depending on deposit maturities. Medium and long-term loans with maturities exceeding 1 year were to carry interest rates between 11 per cent and 12 percent.

By June 1969, inflation had picked up relative to the period a year before. High inflation rates erode the real value of savings and as such discourage savings. It was decided therefore to adjust interest rates upwards. As a result short-term lending or commercial rates were fixed at 10 per cent. Medium and long term loans with maturities not exceeding 3 years were to carry interest rates between 12-13 per cent. Saving rates were set between 25-32 per cent depending on deposit maturities.

The Uganda interest rate structure has contributed to the expansion of domestic credit. Since 1968 nominal interest rates for commercial loans have gradually risen from 10 per cent to 12 per cent, while deposit rates have ranged from 2 per cent to 10 per cent on demand deposits to a maximum of 12 per cent on one-year time deposits.

On July 1, 1970 the Government introduced an across-the-board increase of 1% percentage points in most interest rates as part of its new economic measures for 1970/71.

T A B L E 5
STRUCTURE OF INTEREST RATES: 1988
(annual percentage)

	1988	
	July	December
Bank of Uganda		
Ways and Means	13.0	15.0
Re-discount rate	38.0	28.0
Bank rate to Commercial Banks	45.0	45.0
Treasury Bills		
35 days	32.0	33.0
63 days	35.0	35.0
91 days	38.0	39.0
Government Stocks		
5 years	38.0	40.0
10 years	40.0	42.0
15 years	43.0	45.0
Commercial Banks		
Deposit rates		
Demand deposits	15.0	15.0
Savings deposits	28.0	28.0
Time Deposits		
3-6 months	29.0	29.0
4-12 months	30.0	30.0
Minimum one year	33.0	33.0
Lending rate:		
Agriculture	32-36	32-36
Commerce	40.0	40.0

SOURCE: Uganda: Background to the Budget, 1988-1989

INTEREST RATES IN NIGERIA

The principal objectives of interest rate policy in Nigeria have been to reduce inflationary pressures, promote savings, improve the allocation of resources and to involve domestic non-bank financial institutions in the country's development effort. The interest rate structure has been revised frequently and in many instances a more flexible interest rate policy was adopted. This policy has taken into consideration the need for less costly credit to priority sectors. Thus, agriculture, industry and housing are usually prefered in interest rate while relatively high interest rate is charged in other sectors.

As it can be seen from the table below, it is clear enough to understand the degree of preference given to priority sectors as opposed to the other. In 1988, the lending rate ranges fromm 11 per cent to 19.25 per cent, preferred sectors getting the lowest rate while higher interest rate for non-preferred sectors.

T A B L E 7

STRUCTURE OF INTEREST RATE: 1988
(in per cent)

Minimum Rediscoun	12.75
Treasury Bill issue rate	11.75
Treasury certificate (1 yr.)	12.25
Treasury certificate (2 yrs.)	12.75
Federal Government stock	13.25-14.50
Deposit rates (commercial banks)	12.00-16.00
Saving deposits	10.00-12.50
Lending rates	11.00-19.25

SOURCE: Central Bank of Nigeria: Annual Report and statement of accout, for the year ended 31st December, 1988.

As shown in the table above, deposit rates ranges from 12-16 per cent depending on amount and maturity of the relevant deposit category. The interest rate on savings deposits of commercial banks ranges from 12-12.5 per cent. The lending rates ranges from 11-19.25 per cent, the maximum charges being for non-preferred sectors. This suggests that, in Nigeria, preferential treatment in interest rate is practiced.

III. DIRP IN THE CONTEXT OF AAF-SAP

The policy instruments and measures that must be modified under AAF-SAP is interest rate policy. As mentioned earlier, interest rates adjustments may not work due to the imperfect nature of the African money and capital market. Thus, high lending interest rates encourage speculative rather than productive activities. Moreover, high interest rates will contribute to high inflation and may be of little relevance to the rural sector due to the weak and narrow financial structure.

To alleviate this problem, the use of preferential interest rates is recommended. The use of selective interest rates in such a way that interest rates on loans for speculative activities would be greater than the rates on loans for productive activities would shift resources to productive activities.

As mentioned earlier, interest rates are an important policy instrument in determining saving and investment. They also determine the demand for domestic financial assets and affect the current and capital accounts in the balance of payments. However, their importance varies among developing countries because of differences in the degree of the development of financial markets, the degree of separation of saving and investment decisions, and the freedom permitted to inward and outward capital movements.

There is a widespread reluctance among developing countries to allow interest rates to be determined in the market. This is because in these countries, interest rates are expected to serve various policy objectives other than bringing the demand for and supply of funds into equilibrium. As a result, there is a tendency to apply differential interest rates.

There are various reasons for granting preferential interest rates. The reasons may be forms of market failures, such as economies of scale, external economies and diseconomies and infant industry requirements. The other reasons may be political and social considerations, such as, special needs of industries of national interest or housing needs of low income groups.

However, the selection of priority sectors and activities for preferential interest rates must be specific to the structural conditions and the policy goals of each country. Therefore, that selection may vary from one country to another and from one period to another depending both on the evolution of its structural conditions and, especially of its government policy goals.

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